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DE RUEHLM #0218/01 0410537
ZNR UUUUU ZZH
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FM AMEMBASSY COLOMBO
TO RUEHC/SECSTATE WASHDC 2537
RUCPCIM/CIMS NTDB WASHDC
RUCPDOG/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUEHCG/AMCONSUL CHENNAI 6341
RUEHKA/AMEMBASSY DHAKA 8909

RUEHIL/AMEMBASSY ISLAMABAD 5792
RUEHKT/AMEMBASSY KATHMANDU 3826
RUEHGV/USMISSION GENEVA 1000

UNCLAS COLOMBO 000218

SIPDIS

STATE FOR EB/IFD/OIA AND SA/INS
STATE PASS USTR
STATE PASS OPIC, TDA, EXIM

TREASURY FOR DO/GCHRISTOPOLUS; USDOC FOR ITA/ATAYLOR

SIPDIS

E.O. 12958: N/A
TAGS: [EINV](#) [EFIN](#) [ETRD](#) [ELAB](#) [KTDB](#) [PGOV](#) [OPIC](#) [USTR](#) [MV](#)
SUBJECT: IMI - INVESTMENT CLIMATE STATEMENT 2006 -
MALDIVES

REF: (A) 05 STATE 211900
(B) 05 STATE 202943

¶1. THE FOLLOWING IS THE INVESTMENT CLIMATE STATEMENT
FOR MALDIVES FOR 2006

INVESTMENT CLIMATE STATEMENT
MALDIVES

FEBRUARY 2006

¶2. Maldives is comprised of over 1,190 islands, of which 198 are inhabited and 87 are exclusive resort islands. The local population is about 285,000, and over 600,000 tourists arrive annually. Over the past decade, real GDP growth averaged over 7.5 percent per year, powered mainly by growth in tourism and its spin-offs in transport, communication, and construction. Per capita income was \$2,100 in 2004, compared to an average of about \$500 in the rest of South Asia. While income disparity remains high, this growth also resulted in considerable social progress. The net enrollment in primary education was close to 100 percent. Literacy rates were about 98 percent. Infant mortality and maternal mortality were declining rapidly. One week before the Tsunami disaster, the United Nations decided to graduate Maldives

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from the group of Least Developed Countries (LDCs) and was granted a three year grace period to prepare for the transition, though this has been subsequently put on hold due to the impact of the tsunami.

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¶3. The Asian tsunami in December 2004 caused extensive economic losses to Maldives. Total damages were initially estimated by donors at around \$470 million -- close to 62 percent of GDP. This figure did not include loss of private assets and incomes. Fourteen inhabited islands were destroyed and another 39 suffered severe damage. A few resort islands also suffered extensive damage. Most losses were concentrated in housing and tourism, with education, fisheries, and transport also heavily affected.

The latest estimates put the recovery cost at \$393 million excluding \$100 million in damages to resorts, the bulk of which was covered by private insurance. Although reconstruction has begun, the recovery process remains under-funded. Maldives requires about \$140 million to bridge the funding gap. The Government continues to seek external assistance from donors and to explore foreign investment to cover the shortfall. Shelter, power and energy, disaster management and infrastructure are key sectors requiring additional funds. The reconstruction effort presents an opportunity to address longstanding issues such as providing safe water, sanitation, health and education for island populations and empowering them.

¶4. As a result of the tsunami, the Maldivian economy contracted by about 5.5 percent in 2005 compared to an 8.8 percent growth rate in 2004. A dramatic tourism sector decline following the tsunami has been a major cause of the economic downturn in 2005.

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Tourist arrivals declined by about 50 percent in the first half of 2005, with total arrivals for the year likely being about 35 percent less than 2004, reflecting a substantial recovery towards the end of 2005. Tourism is expected to remain the main driver of the economy in the post-tsunami era. The island resorts, for the most part, experienced only minor damage. Maldives is intensively marketing its status as a unique tourist destination. The second largest economic sector, fisheries, which contributes about 9 percent of GDP, has continued to grow following the tsunami, despite substantial losses to small boats and fisheries infrastructure. Most of the larger vessels were not damaged and are being fully utilized. The loss of agricultural land and livelihoods of island communities has been substantial. In addition to the tsunami, high oil prices have also dealt a blow to the economy due to the high dependency on air transport for tourism, marine transport for travel between the islands and a heavy reliance on oil for electricity generation.

¶5. The impact of the tsunami on the Government budget was also substantial as reconstruction spending increased and revenue (especially from tourism) declined. The government has received about \$83 million in grant assistance to cover tsunami related expenditure in 2005. Foreign grants of about \$130 million are

expected in 2006. It is estimated that the budget shortfall, after accounting for grants, will be about \$100 million in 2005 and \$165 million in 2006. Budget support is expected from the World Bank and the ADB following a planned IMF review in March 2006. Inflation, which had been flat and falling for some years, picked up sharply in 2004-2005 to about 6 percent.

¶6. Maldives is also experiencing adverse impacts on its balance of payments due to the tsunami. The current account deficit is expected to widen sharply, reflecting the steep drop in tourism and rising reconstruction related imports. On the export side, while fish exports have increased substantially (about 20 percent), apparel exports disappeared following the expiration of the Multi Fiber Agreement (MFA) which sets quotas for developing country garment exports in developed countries. The garment industry was comprised entirely of foreign investors, mostly from Sri Lanka, seeking quota advantages. However, the effects on the economy are expected to be negligible since the apparel industry yielded little value-added and imported all inputs. Additionally, even its labor force was imported: most workers in garment factories were Sri Lankan. The main effect of the factory closings was about a 4 percent loss of government revenues derived from land rentals.

¶7. The tsunami further demonstrated that Maldives, which has a narrow economic base relying on tourism and fisheries, needs to promote economic diversification to reduce vulnerability to external shocks. This has been known for sometime; but how to diversify such a small resource-poor nation is a challenge. A recently released Strategic Economic Plan for Maldives, prepared by the International Trade Institute of Singapore at the request of the Government of Maldives, recommends several actions to reduce the volatility and the vulnerability of the economy and to mitigate adverse impacts of possible LDC graduation. The study proposes extensive diversification of fisheries and tourism, and

expansion of agriculture to meet requirements of the tourism sector and island populations. By capitalizing on the growth of these traditional sectors, the study recommends Maldives expansion into new areas such as ports and logistics services, information and telecommunications, and offshore financial services.

¶18. The United Nations Development Program (UNDP) and the Asian Development Bank (ADB) along with other multilateral and bilateral donors are active in Maldives providing assistance to improve basic economic infrastructure and services to promote economic diversification, employment opportunities and regional development. The government is preparing its Seventh National Development Plan which will identify major development projects for the next five-year period.

¶19. There may be commercial opportunities especially in the construction sector and in the supply of equipment in the post tsunami recovery program.

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OPENNESS TO FOREIGN INVESTMENT

¶10. Maldives began opening up to foreign investment in the late 1980s. The government of the Republic of Maldives introduced a Foreign Investment Services Bureau (FISB) in 1987, within the Ministry of Economic Development and Trade. The lack of a strong legal and procedural regime for investment and an over-reliance on negotiations makes the job of the FISB difficult and presents an added risk for investors. The FISB offers "one-stop shop" services to investors and incentives such as 100 percent foreign ownership, duty exemptions and no exchange controls or restrictions on repatriation of profits. At present, personal income taxes are not imposed, though banks' profits are taxed and a corporate profit tax is under consideration for the end of the decade. Domestic and international arbitration is available for dispute settlement.

¶11. Foreign investment is governed by Law 25/79 (passed in 1979), which provides for an agreement between the government and an investor. The Law of Contract governs contractual relationships, and a separate law (no. 4/79) governs business and trading activities by foreign nationals. Investment agreements are for an initial period of 5 to 10 years for investments less than \$1

million, and can be renewed thereafter. For larger projects, terms are negotiable. Foreign investors qualify for import duty concessions as specified by the FISB.

¶12. The Government is committed to improving the investment regime and speeding up the approval process. The FISB is in the process of amending the FISB law with the help of the Foreign Investment Advisory Service (FIAS) of the World Bank group. Currently, approvals for new investments take about one month, and in some cases, when the investment is similar to previous investments, immediate approval is given. The Economic Review Committee reviews all proposed investments in "restricted" and "approval with restrictions" areas or in areas involving environmental or social impacts prior to granting licenses.

¶13. There are several foreign investments in Maldives, primarily in resort management, but also in accounting services, banking, telecommunications, air transport, courier services, and manufacturing.

¶14. The FISB encourages investment projects which: (1) are capital intensive; (2) enhance technology transfer; (3) introduce new skills and offer training to local employees; and, (4) are environmentally friendly. The FISB has identified several industries that offer potential for investors, which are summarized below.

¶15. Value Added Fisheries- fish processing is open to foreign investment, particularly for new technology and capital investment. Opportunities also exist for marine product development and aquaculture, including tropical fish farming and

cultivation of seaweed, lobster, shrimp, reef fish and crab.

¶16. Financial- banking, accounting, and management consulting. The FISB is interested in bringing in more global banks (only HSBC is currently present). The present lack of adequate banking laws has deterred entry.

¶17. Transport and other services- development of air and sea transport including inter-atoll transport services, bunkering, transshipment, and passenger cruises. The development of a transshipment port in the north of the country for cargo bound for Pakistan and the west coast of India is one of the highest priorities. The government's goal is to develop a port that handles 1.3 million twenty foot equivalent units (TEUs) annually and open nearby islands for industries, duty free shopping, and export processing zones. The Government seeks financing and intends to begin construction as soon as possible. Other key priorities in the transport sector are the expansion of the Male' Airport, a bridge connecting the capital city Male' with Hulhumale, and a new commercial port in the Male' region. The new resorts to open in the next few years will also require transportation options from tourist arrival locations.

¶18. Other infrastructure development opportunities include harbors and tourist resorts, residential/retirement islands for foreigners, health resorts, and time-share plans. There are two major development plans in the government's docket. The first is a consolidation of services and infrastructure of the 20 atolls around five regional centers, two of which have already been established. The second is a capital project to alleviate overcrowding in Male'. Reclamation and development of Hulhumale Island, near Male', has already commenced. Hulhumale is projected to house 50,000 people when the first stage of the project is completed in 30 years and 150,000 when all three stages are complete. However, cost of real estate on that island as well as a cultural preference to not commute from another island appears to be significantly slowing utilization of Hulhumale. Currently 1,000 people are in residence on the 465 acres of reclaimed land. Basic amenities, such as electricity, water and telecommunications, are being provided by the government at the same rates as Male'. The government plans to offer 125 acres of duty-free shopping, hoping to increase Maldives' attraction for tourists. There will be potential opportunities in civil works, supply of equipment and investment in the above projects. The government is also currently funding harbor-dredging projects for 103 islands on a contract basis. While infrastructure development remains a top priority for the government, some of the projects

listed above have been slowed as tsunami reconstruction work takes priority.

¶19. Other sectors with potential opportunities include:

Tourism: Opportunities exist in the entire range of services, including development and management of resorts, tourist activities, and land and sea transportation. In 2005, the Government awarded tenders for the development of 11 new resort islands. As of February 2006, however, only four were under construction as unsuccessful bidders continue to raise challenges to the tender process. The Government has opened 35 additional islands for resort development in 2006 and intends to establish streamlined tender processes to make bidding less costly and more transparent.

Telecommunications: Currently, Dhiraagu, jointly owned by UK's Cable and Wireless and the Government of Maldives, is the main provider of telecommunications services. Dhiraagu's monopoly on cellular services ended when Wataniya International of Kuwait commenced operations in August 2005. There are two ISP providers: Focus Computers and Dhiraagu. In the past few months, numerous wireless communication "hot spots" have sprung up around Male'. Telecommunications operators are in the process of establishing two optical fiber gateways, currently expected to be ready by January 2007.

Information Technology: The FISB would like to establish a "technology island" for software development and other IT activities. While the connectivity infrastructure is not yet in

place to support such an operation, is the Government believes that Maldives' climate, surroundings and pace of life would be attractive to software developers.

Other sectors include petroleum exploration; marine-based agriculture; health services, medical facilities and horticulture.

¶20. Sectors closed to investment: trading and the production of any items illegal to import into Maldives.

CONVERSION AND TRANSFER POLICIES

¶21. There are no exchange controls or restrictions on currency movements. Repatriation of funds and profits is allowed, after local debts are settled.

¶22. Major international currencies can be bought and sold at banks and authorized moneychangers. Hotels and banks accept major credit cards and traveler's checks. Foreign-currency accounts are available through banks. The US dollar is the most widely used foreign currency and is accepted by small shops and taxi drivers in Male'.

¶23. The official exchange rate is set at 12.8 Rufiyaa to the dollar. The currency underwent a nine percent devaluation in July 2001 after staying at 11.77 Rufiyaa to the dollar for several years. The Maldivian currency is non-convertible and its true value cannot be determined. However, the Maldives Monetary Authority (MMA) is currently working on a computer upgrade to help track currency movements and provide better information on currency flows. The Government has noted that it will need to review the exchange rate policy in the next few years in order to promote export diversification. The heavy dependence on imports is a constraint for exchange rate management, though tourist receipts help maintain hard currency liquidity. During 2001-2002, businesses reported hard currency shortages and difficulty obtaining dollars at banks. Large fiscal deficits financed by Maldives Monetary Authority posed a potential threat to the fixed exchange rate system, and so the Government took steps to achieve fiscal consolidation during 2003. The fiscal deficit was 4.6 percent of GDP and 3.6 percent of GDP in 2003 and 2004 respectively. The deficit was financed mainly through foreign grants and loans. Public debt, which was 46.5 percent of GDP in 2003, decreased to 38.5 percent in 2004. Debt servicing has been manageable, since most external borrowing is contracted on concessional terms. Due to tsunami related expenditure, the budget deficit is estimated to increase sharply during 2005-2006.

The deficit will be financed through foreign grants and loans and domestic borrowing. World Bank and the ADB are expected to provide budget support following an IMF review in March 2006.

¶24. To enable more comprehensive and up-to-date control over public expenditures, initial actions have been taken to introduce a new public accounting system. The Parliament is expected to pass a new Public Accounting bill in early 2006. Additional draft bills have been prepared, including a public finance bill and amendments to the Audit Bill. However, there has been a delay in their submission to the People's Majlis legislative body. Instead, several Presidential decrees have been issued on these subjects. The Government has also taken steps to expand the tax base and is planning to enact a business profit tax and a property rental value tax. Foreign reserves at end of October 2005 were \$199 million, only slightly lower than end 2004 reserves of \$205 million, and were sufficient to finance 3.3 months of imports.

EXPROPRIATION AND COMPENSATION

¶25. According to the Law on Foreign Investment (25/79) the Government may, with or without any given notice, suspend an investment, either where the investor indulges in an act detrimental to the security of the country or where temporary closure is necessary in the interest of national security. If after due investigation, it cannot be concluded within 60 days of the temporary closure that the foreign investor had indulged in an activity detrimental to the security of Maldives, then the

Government will pay compensation. Capital belonging to an investment that is closed for the above reasons may be taken out of the country in a mutually agreed manner. There does not appear to be any risk of expropriation in the near future.

DISPUTE SETTLEMENT

¶26. The sources of law in Maldives are its constitution, Islamic Sharia law, international law, and English common law, with the latter being more influential in some areas, such as commercial law. In November 2005, the government announced the creation of a 10-member judicial services commission, led by the chief justice, responsible for appointing, dismissing, and examining the conduct of all judges. The commission recommends a group of candidates for judgeships to the President. While the President will then choose from the list of candidates, the commission maintains the right to accept his choice or veto the President's selection. There is a High Court in Male' as well as lesser courts (the number to be determined by the President) in Male' and on other islands. There are no jury trials. The High Court serves as court of appeal and also handles any politically sensitive cases. There are also eight lower courts in Male' dealing with theft, debt and property cases.

¶27. Ultimate appeal lies with the President. In this process, the President is briefed by an advisory board which goes through the appeal and recommends that the President affirm or vary the decision of the High Court. Under a November 2005 Presidential decree, this advisory board was given substantial independence within the confines of the constitution. This arrangement is an interim one until the constitutional changes -- which could establish an independent supreme court.

¶28. Though the legal practices are adequate, the judicial process is slow. The law on foreign investments guarantees the security of investments. Disputes involving investments below \$1 million can be referred to the courts in Maldives. Disputes over \$1 million can be referred for international arbitration.

¶29. Recognizing that the existing legal and commercial framework is underdeveloped and not always fully transparent or predictable, the government is promoting administrative reforms and formulating regulations dealing with labor, the environment and industry. In recent years, the People's Majlis has enacted a number of commercial laws, including the law of contract, the Negotiable Instruments of Law, and the Companies Act, and amended the tourism law to conditionally extend the 25-year resort lease period to 50 years. Maldives is not a member of the International Center for

the Settlement of Investment Disputes (ICSID).

RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

¶30. There is little private ownership of land. Land reform currently under consideration may result in more trade and private ownership of property. Foreign investors are not allowed to own land, but are granted lease rights ranging up to 25 years, which can be later extended to 35 years for investments over \$10 million, or 50 years if 50 percent of the company's shares are floated on the Maldives trading floor. Leases can be renewed at the end of their terms, but the formula for assessing compensation value of a resort at the end of a lease has not yet been developed. The Cabinet has agreed to extend the initial lease period from 25 years to 99 years. Relevant legislation is expected to be presented to Parliament by mid-2006.

PROTECTION OF PROPERTY RIGHTS

¶31. Maldives lacks specific legislation to protect intellectual property rights (IPR) and has not signed on to international agreements and conventions. Maldives stands to benefit from the recent WTO decision to extend the transition period for least-developed countries (LDC) to provide protection for intellectual property under Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement until July 1, 2013, unless it graduates

from being an LDC. The transition period was due to expire on January 1, 2006. Consumers of computer software reportedly appreciate the value of genuine products, as pirated software programs often contain bugs and viruses.

EFFICIENT CAPITAL MARKETS AND PORTFOLIO INVESTMENT

¶32. The financial sector in Maldives is very narrow and dominated by the banking sector. The banking sector consists of one publicly owned commercial bank -- the Bank of Maldives -- and branches of four foreign-owned commercial banks. HSBC, the only global bank present, set up operations in 2002. Non-bank financial institutions in the country consist of two insurance companies, a provident fund and a finance leasing company. All financial institutions currently operate under the supervision of Maldives Monetary Authority, which acts as the Central Bank.

¶33. Local sources of finance are limited in scope because of the small size of the capital market and the lack of instruments that are available in more developed nations. No financial instruments are offered to the public. The commercial banks provide short- and long-term credit to the private sector. No specialized financial institution exists to meet the investment needs of tourism, agriculture and fisheries. Non-performing loans are about 6 percent and the risk-weighted capital adequacy ratio is high. Most foreign currency loans are made to foreign currency-earning tourist enterprises. The Maldives Monetary Authority has introduced an emergency liquidity facility for commercial banks. Banking supervision has been recently upgraded, moving toward international best practices.

¶34. The development of a stock market has been a policy objective of the Government of Maldives since the late 1990s and has been integrated in consecutive National Development Plans. As there is currently no organized capital market in Maldives, the Capital Market Development Section (CMDS) of the MMA is working towards creating the institutional mechanism to facilitate an organized market for raising capital required by the economy. A proposed Securities Bill would make provisions for the establishment of a regulatory framework for the capital market, the proposed capital market institutions and the licensing of financial intermediaries for the purpose of developing and regulating a capital market in Maldives. A small trading floor opened in Male' in April 2002 within the capital development department of the MMA. At present, the only investment opportunity available to the public is a limited number of shares in the Bank of Maldives and two other state-owned public companies - Maldives Transport and Contracting Company (MTCC) and the State Trading Organization (STO). There are plans to expand into the islands, and the MMA is conducting an

investor education program. There are hopes that the stock exchange will facilitate the development of a capital market. A leasing company, Maldives Finance Leasing Company (Pvt) Ltd (MFLC), was established in May 2002 as a collaborative venture between five domestic public and private sector entities and two international parties including the World Bank's International Finance Corporation (IFC). The MFLC aims to address the demand for long-term equipment financing from all sectors of the economy. The Asian Development Bank will support strengthening the financial sector to more effectively mobilize savings and fund long-term development.

¶35. The Housing Development Finance Corporation is a government company designed to provide public housing loans with long repayment terms at favorable interest rates. The Company is also entrusted with drawing up the policy that plans and facilitates the use of land as an asset in Maldives, and to bring the necessary changes and the subsequent development of economic and financial mechanisms in the country, to incorporate this policy.

POLITICAL VIOLENCE

¶36. Maldives has a homogeneous society of one culture, one religion and one language. The current President has been in office since 1979. In 2004, the Government initiated a process of constitutional reforms to address calls for change and democracy.

A Special Majilis (a special parliament separate from the People's Majlis) was established in May 2004 specifically to consider proposed amendments to the constitution. Parliamentary elections in January 2005 saw some reformists entering Parliament. In 2004 the President presented detailed proposals for constitutional reform to the Parliament. In June of 2005, Parliament legally recognized political parties. Reformists complained that reform programs were slow and insufficient. Opposition groups held demonstrations to demand further reforms and request the release of political prisoners in August and November 2005 and January 2006. The demonstrations remained largely peaceful, although after the first such protest in August, several people were arrested and parliament was temporarily suspended. The arrested demonstrators were later released without charge. Several reform bills are due to come before Parliament in February 2006.

CORRUPTION

¶37. In 2002, Parliament passed a bill on the prevention and punishment of corruption. The provisions of the law cover definitions of bribery and improper pecuniary advantage and prescribe punishments. The law also outlines procedures for the confiscation of property and funds obtained through commission of the included offenses. It broadens the mandate of the Anti-Corruption Board, which previously extended only to government employees, to investigate corruption in the private sector.

OPIC AND OTHER INSURANCE PROGRAMS

¶38. Currently, OPIC does not operate in Maldives. Maldives is also not a member of the Multilateral Investment Guarantee Agency of the World Bank Group.

LABOR

¶39. Skilled and unskilled labor can be scarce, and expatriate labor is allowed in order to meet shortages. There are an estimated 33,800 expatriate workers, mostly in tourism, construction, and social and personal services. Expatriate labor is equal to or more expensive than local labor. While salaries are lower, travel and other benefits typically make expatriate overall costs higher.

¶40. Wages in the private sector are usually set by contract between employer and employee and are generally based on rates for similar work in the public sector. Employment contracts usually specify work hours on a weekly or monthly basis. Employees are

usually authorized 20 days of annual leave, 30 days of medical leave, 45 days of maternity leave, and 10 days of special annual leave for "extraordinary circumstances." There are no laws governing health and safety conditions; however, there are regulatory requirements that employers provide a safe working environment and ensure the observance of safety measures.

¶41. Maldives is not a member of the International Labor Organization. Although unions are not expressly prohibited, the Government does not recognize the right to form unions or the right to strike. Hence, labor actions and disputes are rare. The US Government in 1995 suspended Maldives' eligibility for tariff preferences under the US Generalized System of Preferences (GSP) because the Government failed to take steps to afford internationally recognized worker rights to Maldivian workers. The Government has drafted new labor laws dealing with rights of association, the right to organize, and acceptable conditions of work, and has promised to pass them into law. The US Government has offered technical assistance to review the draft legislation.

¶42. Foreign Investment: US firms represented in Maldives include Western Union, FedEx, UPS, Hewlett Packard (HP), Dell, Compaq, Coca-Cola, American Express, Hilton Resorts, SeaTec, Ernst and Young, Price Waterhouse Coopers and KPMG.

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